Supreme Court of the United States

October Term, 1941

WALLACE GROVES,
Petitioner,
against
UNITED STATES OF AMERICA,
Respondent.

No. .....

BRIEF IN SUPPORT OF PETITION

Opinion Below

The opinion of the United States Circuit Court of Appeals for the Second Circuit is not yet reported but will be found annexed to the transcript of the record. There was no opinion by the United States District Court for the Southern District of New York.

Jurisdiction

The opinion of the Circuit Court was rendered on August 4, 1941. On August 15, 1941, an order was entered staying the mandate of the Circuit Court of Appeals for the purpose of permitting the within application for a writ of certiorari.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

Statement of the Case

The statement of the case is contained in the petition.

Specification of Errors

I The Circuit Court erred in holding that the use of inside information by a fiduciary for his benefit and to the detriment of his *cestui* constitutes a violation of Section 215 of the Criminal Code.

II The Court erred in holding that non-disclosure by a fiduciary constitutes common law deceit.

III The Court erred in determining that the allegations of affirmative misrepresentation had been proved.

IV Even if non-disclosure by a fiduciary constitutes deceit, the Court erred in holding that evidence of non-disclosure proved the scheme of affirmative misrepresentation charged in the indictment.

V Even if the crime of fraud by misrepresentation could be proved by non-disclosure, the Court erred in holding that non-disclosure had been proved.

VI The Circuit Court erred in sustaining the use by the United States Attorney of the Grand Jury process to compel the defendant either to testify or subsequently be cross examined thereon.

ARGUMENT

I

The Circuit Court erred in holding that the use of inside information by a fiduciary for his benefit and to the detriment of his *cestui* constitutes a violation of Section 215 of the Criminal Code.

Question Properly Raised

The indictment charged that the preferred stock transaction was a fraud because Warriner made four specific misrepresentations to the GIC directors (see Petition, p. 4). In the absence of evidence of misrepresentation, the Court was requested to withdraw these allegations from the jury, but refused (fols. 2428-2432) and exceptions were taken (fol. 2509).

Instead, the trial Court instructed the jury as follows (fols. 2471, 2472):

> "In this case, for instance, Warriner was president of General Investment Corporation. As president it was his duty under the law, as well as in morals and justice, to acquaint the directors of that company with all that he knew of the circumstances attending the Devendorf stock sale. His silence in that regard, indicated by the minutes of the corporation if you accept them, if intended by him to lull the directors into a belief that they were acting for the best interests of the corporation and doing something in ignorance which they would not have done with knowledge, would be a misrepresentation."

An exception was duly taken (fols. 2501, 2502).

The Circuit Court in its opinion did not mention this instruction which was the subject of an assignment of error, but affirmed on the theory that the use for profit

of inside information by a fiduciary is mail fraud, irrespective of misrepresentation. Thus, the Circuit Court has rested its affirmance upon facts not charged in the indictment and upon a breach of fiduciary duty not within the contemplation of the mail fraud statute.

Mail Fraud is Deceit

The crime of mail fraud is, in effect, common law deceit. In *U. S.* v. *Brown*, 79 F. (2d) 321 (C. C. A. 2d), the Court said, per LEARNED HAND, *C.J.* (p. 325):

> "The crime was deceit, and we agree with the Eighth Circuit that the liability runs *pari passu* with civil liability. Foshay *v.* United States, 68 F. (2d) 205, 211 (C. C. A. 8). The Supreme Court has not indeed said so expressly, but that seems to us to be the presupposition of Durland *v.* U. S., 161 U. S. 306, 16 S. Ct. 508, 40 L. Ed. 709, and U. S. *v.* Comyns, 248 U. S. 349, 39 S. Ct. 98, 63 L. Ed. 287; and we have ourselves so treated it. U. S. *v.* Rowe, 56 F. (2d) 747 (C. C. A. 2); *Pelz* v. *U. S.* 54 F. (2d) 1001 (C. C. A. 2). *Cf.* Harrison *v.* U. S., 200 F. 662, 665 (C. C. A. 6). It was therefore necessary for the prosecution to allege and prove utterances about existing facts which were untrue and known to be so."

In *Foshay* v. *U. S.*, 68 F. (2d) 205 (C. C. A. 8th), the Court said, per WOODROUGH, *C.J.* (pp. 210, 211):

> "It is well settled that the criteria of fraud evolved in civil cases are applicable to prosecutions under the mail fraud statute."

In the present case, the Court said:

> "First, the statute is not limited to what would give rise to a civil action, in spite of what was said in another connection in *United States* v. *Brown*, 2 Cir., 79 F. 2d 321, certiorari denied 296 U. S. 650, 56 S. Ct. 309, 80 L. Ed. 462; . . ."

The conflict of the 2nd and 8th Circuits on this issue is, therefore, sharply drawn.

Prior to the decision of the Second Circuit in *U. S.* v. *Buckner*, 108 F. (2d) 921, which will be considered below, it had never been held that a mail fraud could be established by facts not sufficient to prove common law deceit. Indeed, the rule of the *Brown* and *Foshay* cases, that mail fraud was analogous to common law deceit, represented an extension of the scope originally accorded the mail fraud statute.

In *U. S.* v. *Owens*, 17 Fed. 72, the following was said (TREAT, *J.*, p. 74):

> "It appears to the court that the act was designed to strike at common schemes of fraud, whereby, through the post-office, circulars, etc., are distributed, generally to entrap and defraud the unwary, and not the supervision of commercial correspondence solely between a debtor and creditor."

See, also, *U. S.* v. *Mitchell*, 36 Fed. 492.

The broader interpretation adopted in more recent years was undoubtedly largely influenced by *Durland* v. *U. S.*, 161 U. S. 306, where the mail fraud statute was held applicable to promissory representations. This, of course, was in accord with established rules of common law deceit. [BOWER on *Actionable Misrepresentation* (2d Ed. 1927) pp. 35, 36.]

Conduct Other Than Deceit Not Mail Fraud

An earlier judicial effort to expand the scope of the mail fraud statute beyond common law fraud was overruled in *Fasulo* v. *U. S.*, 272 U. S. 620, where the Court said (pp. 628, 629):

> "The rule laid down in the *Horman* case (that blackmail was mail fraud) includes every scheme that in

its necessary consequences is calculated to injure another or to deprive him of his property wrongfully. That statement goes beyond the meaning that justly may be attributed to the language used. The purpose of the conspirators was to compel action in accordance with their demand. The attempt was by intimidation and not by anything in the nature of deceit or fraud as known to the law or as generally understood. The words of the Act suggest no intention to include the obtaining of money by threats. There are no constructive offenses; and, before one can be punished, it must be shown that his case is plainly within the statute. *United States* v. *Lacher*, 134 U. S. 624, 628."

Similarly, the rule of this case includes every act of a fiduciary which results in benefit to himself and a detriment to his *cestui*, whether or not the act was "in the nature of deceit or fraud as known to the law."

In the *Fasulo* case, the Court approved (p. 628) the decision of the Seventh Circuit in *Naponiello* v. *U. S.*, 291 Fed. 1008 (C. C. A. 7th), where the following appears (BAKER, *C.J.*, at p. 1009):

> "Section 215 was aimed originally at using the mails to promote 'schemes or artifices to defraud.' These quoted words show unmistakably that the victim's money must be taken from him by *deceit*." (our italics.)

Thus, in every recorded mail fraud conviction, common law deceit was proved. Cases holding that conduct, not constituting common law deceit, proved mail fraud were overruled by the Supreme Court.

The *Buckner* Case Did Not Hold That Fiduciary Disloyalty Was Mail Fraud

This was the clear state of the law until the decision of the Second Circuit in *U. S.* v. *Buckner*, 108 F. (2d) 921,

where the following interpretation was adopted (CLARK, *C.J.*, p. 926):

> "The statute prohibits any scheme or artifice to defraud, and the word 'defraud' must be construed broadly. Durland *v.* United States, 161 U. S. 306, 16 S. Ct. 508, 40 L. Ed. 709. The elements of fraud developed in civil cases are applicable in prosecutions under the mail fraud laws. Foshay *v.* United States, 8 Cir., 68 F. 2d 205, 210, 211, certiorari denied 291 U. S. 674, 54 S. Ct. 531, 78 L. Ed. 1063. Defendants, as protective committee members, were fiduciaries. Marshall *v.* Lovell, 8 Cir., 19 F. 2d 751, 755. Intentionally converting trust funds to the personal use of the trustees is a patent fraud on the *cestuis* from whom the funds were solicited. Campbell *v.* United States, 9 Cir., 12 F. 2d 873. Using a fiduciary position as a protective committee member to obtain secret profits based upon inside information is not only a breach of trust, but an active fraud on the bondholders. Marshall *v.* Lovell, *supra*, Matter of Republic Gas Corp., Debtor, No. 60281, D. C., S. D. N. Y., June 10, 1936; see In re. Paramount Publix Corp., D. C. S. D. N. Y., 12 F. Supp. 823, 828, affirmed 2 Cir., 83 F. 2d 1015; Michoud *v.* Girod, 4 How. 503, 45 U. S. 503, 553, 554, 11 L. Ed. 1076. The first wrong cannot be defended as negligence, nor can the second be excused on the unsupported assertion that it is common practice for committeemen to trade, for their own account, in the securities represented. Both frauds are schemes to defraud within the purport of the mail fraud statute. Campbell *v.* United States, *supra*."

None of this was necessary to the decision since the facts of the *Buckner* case established a common law deceit. The defendant, member of a bondholders' committee, was engaged in an effort to secure the redemption of bonds by action of the government of the United States and the Philippines. He sought to obtain funds to bribe a Filipino legislator and for other purposes by entering into a scheme with stock brokers whereby in exchange for

information as to the progress of the proposed redemption, Buckner was to receive fifty per cent. of the profits to be made by buying bonds cheaply.

This was nothing more than the ordinary confidence game, involving the obtaining of property under false pretenses. Buckner, under the false pretense of representing bondholders, was, in fact, engaged in a scheme to swindle them by buying their bonds at a depreciated price and pocketing half the subsequent profits.

A new and broader interpretation of the mail fraud statute was therefore not necessary to affirm the *Buckner* conviction. A reading of the opinion, moreover, casts doubt on whether a new interpretation was intended.

The opinion cited and relied on the *Foshay* case. But that decision had been thought to stand squarely for the proposition that mail fraud was common law deceit (*U. S.* v. *Brown, supra*).

The opinion, however, after citing the *Foshay* case, expresses the view that the use of a fiduciary position to obtain secret profits based upon inside information was not only a breach of trust, but an active fraud on the bondholders. Until the decision in this case, it was not clear whether this was intended to be given the broad interpretation which the generality of its language seemed to indicate. The use of a fiduciary position for profit might or might not involve common law deceit.

Ambiguity of *Buckner* Opinion in Citing Cases Not Involving Fraud

A further element of confusion was added by the citation in the *Buckner* opinion of cases involving "constructive" fraud or fraud in law, which, of course, means no fraud (*Derry* v. *Peek*, 14 A. C. 337, 346).

In *Re Republic Gas Corporation*, 35 F. Supp. 300, 303, cited in the *Buckner* case, compensation was refused committee members who had traded in the debtor's bonds.

It was stated (p. 303) that this conduct was "a fraud in law;" and that trustees were not entitled to compensation "even where the fraud is merely constructive."

As to legal fraud or fraud in law, Lord BRAMWELL in an opinion in the House of Lords in *Derry* v. *Peek*, 14 A. C. 337, 346 (1889), said:

> "I think we need not trouble ourselves about 'legal fraud,' nor whether it is a good or bad expression; because I hold that actual fraud must be proved in this case to make the defendants liable, and, as I understand, there is never any occasion to use the phrase 'legal fraud' except when actual fraud cannot be established. 'Legal fraud' is only used when some vague ground of action is to be resorted to, or, generally speaking, when the person using it will not take the trouble to find, or cannot find, what duty has been violated or right infringed, but thinks a claim is somehow made out. With the most sincere respect for Sir J. Hannen I cannot think the expression 'convenient.' I do not think it is 'an explanation which very clearly conveys an idea;' at least, I am certain it does not to my mind. I think it is a mischievous phrase, and one which has contributed to what I must consider the erroneous decision in this case."

In the *Paramount Publix* case, 12 F. Supp. 823, 828, also cited in the *Buckner* opinion, compensation was again denied committeemen who traded in the deposited securities. Compensation for the services of fiduciaries, it was held (p. 828), "necessarily implies loyal and disinterested service." Fraud was not mentioned.

In *Michoud* v. *Girod*, 4 How. 503, 45 U. S. 503, cited in the *Buckner* case, it was held (p. 556) that a trustee, "though strictly honest," cannot buy for himself the estate of the *cestui* by reason of the general policy of equity, "and not from any peculiar imputation of fraud."

The rule applied in these cases, and relied on in the *Buckner* case, was more recently enforced in *Woods* v.

City Bank Co., 312 U. S. 262 (1941). There the Court reversed the decision of the Circuit Court which had allowed compensation to bondholders' committee members who held a conflicting interest in the equity of the property involved, an apartment hotel. Vitally significant is the Court's holding (p. 264) that the committee members were not guilty of "fraud," though in soliciting the deposits of bonds, they had concealed from the bondholders that they represented both the creditors and the debtor (p. 265).

In the *Buckner* case, therefore, decisions were cited denying compensation to committee members who occupied conflicting positions. These cases were cited as authority for the proposition that that conduct was fraud, though this Court in *Woods* v. *City Bank Co., supra,* held the same conduct not fraudulent.

By reason of the facts of the *Buckner* case and the citation of cases not involving fraud, the rule of the *Buckner* case was not clear until the decision of the Circuit Court in the case now presented for review. Here, the Court has stated the following broad rule:

> "But, further, appellant should not succeed, even if there were no 'affirmative misrepresentations' expressly made by Warriner to the board. Warriner's and Groves's joint adventure in trading in G. I. C. stock and making a profit at G. I. C.'s expense was established. *The evidence permitted at least the inference that Warriner's participation was not revealed to the board.* Thus, there was certainly the use by a fiduciary of inside information to his own benefit and to the detriment of his *cestui,* which, when involving use of the mails, as here, we have recently held to be within the contemplation of the mail fraud statute. *United States* v. *Buckner,* 2 Cir., 108 F. 2d 921, certiorari denied 309 U. S. 669, 60 S. Ct. 613, 84 L. Ed. 1016." (our italics.)

This pronouncement ignores the fundamental distinction between common law fraud and "fraud in the sense of a court of equity" (*Moore* v. *Crawford,* 130 U. S. 122, 128). The fact that Warriner's participation was not revealed to the board is relied upon by the Circuit Court as the gravamen of the crime committed, though in the *City Bank Co.* case, the Court, explicitly pointing out that the committee members' conflicting interest had not been disclosed, absolved the fiduciaries of fraud, holding them merely for breach of trust.

Denial of Certiorari in *Buckner* Case Did Not Involve Question Here Presented

Though a petition for certiorari was denied by this Court in *U. S.* v. *Buckner,* 309 U. S. 669, the first two questions presented for review related to the alleged misconduct of the District Attorney and to the propriety of the cross examination of Buckner with respect to his refusal to testify before the Securities and Exchange Commission.

The third question presented was "the broad question as to whether the evidence proved a crime indictable under Section 215 of the United States Criminal Code" (*U. S.* v. *Buckner,* Record on Appeal, Petition, p. 11). This broad statement of the question failed to call specifically to the attention of this Court the question now presented.

The petition added that "the twilight zone between civil fraud and criminal fraud within the meaning of section 215 of the United States Criminal Code may be narrow, but a line should be drawn by this court" (*Id.,* p. 11). This does not touch the question now raised. The distinction is not between civil fraud and criminal fraud, but between "constructive" fraud, which is not fraud at all, and criminal fraud which is the same as civil (common law) fraud.

The petition stated further that ordinary cases of breach of trust or general schemes to defraud bondholders of faithful service of committee members were not schemes to defraud. This language failed to state the question concretely. Common law fraud may also involve as one of its elements a plan to deprive bondholders of the loyal service of committee members.

Circuit Court, in Holding That Mail Fraud Not Limited to Deceit, Ignored Distinction Between Actual and Constructive Fraud

The gist of the error relied upon here is that the Circuit Court has ignored the wide cleavage which exists between actual or common law fraud and constructive fraud, which is said to be fraud in equity. That fundamental distinction, consistently applied by this Court in the interpretation of statutes using the term "fraud", was abandoned in this case.

In *Neal* v. *Clark*, 95 U. S. 704, the question was whether the word "fraud" in the bankruptcy statute referred to "positive fraud" or "fraud in law". In holding that positive fraud was meant, the Supreme Court said, per Mr. Justice HARLAN, at page 709:

> "Applying these rules to this case, we remark, that, in the section of the law of 1867 which sets forth the classes of debts which are exempted from the operation of a discharge in bankruptcy, debts created by 'fraud' are associated directly with debts created by 'embezzlement'. Such association justifies, if it does not imperatively require, the conclusion that the 'fraud' referred to in that section means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement; and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality. Such a construction of the statute is consonant with equity, and consistent with the object and intention of Congress in enacting a general law by which the honest

> citizen may be relieved from the burden of hopeless insolvency. A different construction would be inconsistent with the liberal spirit which pervades the entire bankrupt system."

Strictly confining the term "fraud" to common law fraud, this Court has held not fraudulent under the bankruptcy act a transfer in fraud of creditors (*Wolf* v. *Stix*, 99 U. S. 1); unlawful hypothecation of securities (*Hennequin* v. *Clews*, 111 U. S. 676); and the conversion of pledged property (*Davis* v. *Aetna Acceptance Co.* 293 U. S. 328).

It should be added that the bankruptcy statute provides that liabilities are not to be discharged which are created by the bankrupt's "fraud, embezzlement, misappropriation or defalcation while acting as an officer *or in any fiduciary capacity.*" (our italics.) Although the property in *Davis* v. *Aetna Co., supra,* was held under trust receipt so that literally the bankrupt was a trustee and therefore a fiduciary, the Court held that the bankrupt was not a trustee or a fiduciary within the intent of the statute. It said, per Mr. Justice CARDOZO (p. 333):

> "The meaning of these words has been fixed by judicial construction for very nearly a century. *Chapman* v. *Forsyth*, 2 How. 202, decided in 1844, is a decision to the effect that within the meaning of a like provision in the Act of 1841, a factor does not act in a fiduciary capacity; the statute 'speaks of technical trusts, and not those which the law implies from the contract.' 2 How., at p. 208."

This narrow construction of a civil statute is in sharp contrast to the broad and far-reaching interpretation of the penal statute adopted in this case.

In dealing with fiduciary disloyalty, the Courts have carefully marked the distinction between actual and constructive fraud. A distinction was drawn between "defalcation" by a fiduciary and "fraud" in *Central Hanover Bank & Trust Co.* v. *Herbst*, 93 F. (2d) 510 (C. C. A. 2d),

where it was held that the act of a receiver in spending money allowed him by an intermediate order, without awaiting the outcome of an appeal, was a "delfacation". In so holding, the Court assumed arguendo that the spending of the money was neither a "fraud", "embezzlement", nor "misappropriation". The vagueness of these terms is indicated by the following language of LEARNED HAND, *C.J.* (p. 512):

> "All we decided is that when a fiduciary takes money upon a conditional authority which may be revoked and knows at the time that it may, he is guilty of a 'defalcation' though it may not be a 'fraud' or an 'embezzlement' or perhaps not even a 'misappropriation.'"

The distinction drawn between fiduciary defalcation and fraud attests to the well recognized practice of construing "fraud" in statutes to mean common law deceit.

Purpose to Defraud Not Material

It must be emphasized that this distinction between "constructive" and positive fraud does not depend on proof of a "purpose" to defraud. Viewed realistically, the subjective good faith of the defendant is immaterial in any fraud case. The defendant who honestly believes that he has a right knowingly to misrepresent the facts or acts from kindly motives is guilty of fraud, irrespective of his belief or purpose. The purpose to defraud is inferred from the act which is the knowingly false statement (*Kaplan* v. *United States,* 229 Fed. 389 (C. C. A. 2d); *Nonantum Inv. Co.* v. *Maryland Casualty Co.,* 56 F. (2d) 329 (C. C. A. 1st)).

It is ancient learning that the test of malice, fraud and intent is an objective one, applied without reference to the subjective views of the accused. (Holmes, *Common Law,* pp. 135, 136; *Nash* v. *United States,* 229 U. S. 373, 377). This proposition was applied in *In re Hammond,*

98 F. (2d) 703 (C. C. A. 2d), where the Court had before it an application for discharge of a fiduciary whose liability had been created by reason of the appropriation to himself of an opportunity for investment offered to the corporation. It was undisputed that the fiduciary had had no purpose to despoil the corporation, and was acting largely for the benefit of the company. Nevertheless, the Court held him guilty of an *intentional misappropriation.* It said, per SWAN, *C.J.* (p. 705):

> "But the bankrupt argues that the association of the word with fraud, embezzlement and defalcation implies, under the familiar ejusdem generis rule of construction, that some evil intent must accompany the bankrupt's misappropriation; that Hammond was animated by a desire to obtain for Acoustic the benefit of access to the necessary patents, and had no intention of despoiling his cestui. Implicit in this argument is the assumption that Hammond did not know, and is not chargeable with knowing, the rule of law forbidding him to take over for his own profit a contract of a solvent corporation, even when the corporation is financially unable to perform it. But this assumption is unwarranted; he is chargeable with knowledge of the law. The character of the liability imposed upon a fiduciary for appropriating property of his cestui in violation of his duty is the same whether he has actual knowledge that the law imposes the duty or is merely charged with such knowledge. In either event, the appropriation is intentional and, since it is unlawful, it is such a 'misappropriation' as, in our opinion, excepts the liability from release by a discharge in bankruptcy."

If the use for profit of inside information by a fiduciary is mail fraud, the crime is established irrespective of the good faith of the fiduciary since he is charged with knowledge of the law.

The decisive question is whether the conduct violates the applicable rule of law. If it does, the requisite intent follows from the doing of the act. A claim that a lawful

act is done with fraudulent intent amounts to nothing; as does a defense that an unlawful act was performed in good faith. This is illustrated by *McLane* v. *King*, 144 U. S. 260, where the Court said, per Mr. Justice BREWER (pp. 262, 263):

> "In other words, it is not shown that King & Son did other than exercise a legal right of collecting a just debt by foreclosure of the mortgage given to secure it. By so doing, they exposed themselves to no liability to others for the indirect result of such legal act. The allegation that it was done with a fraudulent intent and purpose to obtain possession of the bridge, amounts to nothing. If the act was legal, it is not made illegal by a mere epithet."

It must be determined, therefore, in this case, whether the use for profit of inside information by a fiduciary for his benefit is a mail fraud. Honesty or good-faith in any other sense is not material.

Undisclosed Use of Fiduciary Position for Profit Cannot be Mail Fraud Since Such Conduct is Frequently Permissible in Equity

There are numerous instances in which the use for profit of inside information by a fiduciary is condonable even in equity.

Directors, acting upon the basis of inside information, may purchase claims held by strangers against the corporation at a discount and enforce the claims against the corporation for the full amount. Liability in equity depends upon whether the failure of the corporation to purchase the claim for itself is due to the act of the fiduciary (*In Re New York Railways Corp.*, 82 F. (2d) 739 [C. C. A. 2d]; *Ripperger* v. *Allyn*, 25 F. Supp. 554 [S. D. N. Y., PATTERSON, *D. J.*]).

The corporate fiduciary who purchases corporate obligations at a discount and then collects the full amount

from the corporation, has clearly made use of inside information for his own benefit. His conduct is nevertheless lawful, regardless of any failure to disclose the transaction to the corporation.

A fiduciary is under a mandate to turn over a business opportunity to his corporation only when (1) the offer has been made to the corporation and not to the director as an individual; or (2) he has been instructed by the corporation to negotiate for such opportunities; or (3) the opportunity is essential to the continued existence of the corporation; or (4) where he avails himself of corporate assets in furthering the new enterprise. *Hauben* v. *Morris*, 255 App. Div. 35 (1st Dept. 1938), aff'd 281 N. Y. 652; *Irving Trust Co.* v. *Deutsch*, 73 F. (2d) 121, cert. den. 294 U. S. 708; *Guth* v. *Loft, Inc.*, 5 A. (2d) 503 (Del.), aff'g 2 A. (2d) 225 (Del. Ch.); *Litwin* v. *Allen*, N. Y. L. J., Dec. 20, 1940, p. 2134 (Sup. Ct. N. Y. Co., SHIENTAG, *J.*); *Solimine* v. *Hollander*, 128 N. J. Eq. 228, 16 A. 2d 203; *Liability of Directors for Taking Corporate Opportunities, etc.*, 39 Columbia Law Review, page 219.

However, under the broad language of the opinion of the Circuit Court in the instant case, the use of inside information for profit in any situation although condonable in equity under the above rules would be deemed a mail fraud.

Certainly, it is strange doctrine

> "that that which on the equity side of the court is allowable conduct may in a criminal proceeding become the road to prison." (*U. S.* v. *Hutcheson*, 312 U. S. 219, 234, 235, per Mr. Justice FRANKFURTER.)

Statute, If Interpreted to Include Conduct Other Than Deceit, is Invalid

It is submitted that the reason for the error of the Circuit Court in this case is the great generality and vagueness of the term "fraud". Fraud is regarded as a

nomen generalissimum and is customarily referred to as a generic term. It has been used to describe not only deceit but perjury,[1] forgery,[2] undue influence,[3] inadequacy of consideration[4] or any transgression of equitable rules.[5]

> *Bower on Actionable Misrepresentation*, p. 397;
> *Story's Equity Jurisprudence* (14th ed.), Vol. 1, p. 262;
> *Pomeroy's Equity Jurisprudence* (4th ed.), Vol. 2, pp. 1802, 1803.

If the statute be interpreted to include fraud in this generic sense, it is submitted that the statute is invalid for vagueness and uncertainty.

Bower on *Actionable Misrepresentation* (p. 397) defines fraud as follows:

> "'Fraud' has always been treated by Chancery Judges as a *nomen generalissimum*. This generic term, in equity, has from the earliest times (g) been used to connote no more than a transgression of equitable rules, and to denote no less than every species of act or omission which can reasonably answer to that description, such as non-disclosure, unaccompanied by misrepresentation, in contracts and relations *uberrimae fidei* (h), abuse of the influence arising from a dominant position on the one side, and incapacity or distress or necessity on the other, unconscionableness, oppression, and the like, *though nothing is more certain than that actual dishonesty, or 'fraud' in the common law sense, is not required to render such acts or omissions actionable.*" (italics ours.)

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[1] *Reynolds* v. *Evans*, 244 Ky. 267, 50 S. W. (2d) 549.
[2] *Eliason* v. *Wilborn*, 335 Ill. 352, 167 N. E. 101.
[3] *McCormick* v. *McCormick*, 221 Ala. 606, 130 So. 226.
[4] *Branton* v. *Inks*, 149 S. W. (2d) 667.
[5] *Bower on Actionable Misrepresentation*, page 397.

In *Moore* v. *Crawford*, 130 U. S. 122, the following definition of fraud appears (per Mr. Chief Justice FULLER, at page 128):

> " 'Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another. And courts of equity will not only interfere in cases of fraud to set aside acts done, but they will also, if acts have by fraud been prevented from being done by the parties, interfere and treat the case exactly as if the acts had been done.' 1 Story Eq. Jur. § 187."

The reference to fraud "in the sense of a court of equity" marks the traditional distinction between fraud at law and in equity. Whether the origin of equity be found in the law of uses and trusts (*Holmes, Early English Equity*, Vol. 2, *Select Essays in Anglo-American Legal History*, p. 705) or in the issuances of decrees in personam by the Chancellor in cases where no remedy was provided by the common law (*Ames, The Origin of Uses and Trusts, id.*, p. 737), it is elementary that equitable remedies were designed to operate where there was no remedy at law. Fraud "in the sense of equity" necessarily signifies conduct which is not fraud in law.

Up to the decision in the *Buckner* case and in this case, it had been assumed that the mail fraud statute applied to common law fraud, not fraud "in the sense of a court of equity." It has now been squarely held that the mail fraud statute is not limited to common law deceit. The following is said in the opinion in this connection:

> "First, the statute is not limited to what would give rise to a civil action, in spite of what was said in another connection in *United States* v. *Brown*, 2 Cir., 79 F. 2d 321, certiorari denied 296 U. S. 650, 56 S. Ct.

309, 80 L. Ed. 462; for that case itself, and *Wilson* v. *United States*, 2 Cir. 190 F. 427, certiorari denied 221 U. S. 361, 31 S. Ct. 538, 55 L. Ed. 771; *United States* v *Rowe*, 2 Cir., 56 F. 2d 747, certiorari denied 286 U. S. 554, 52 S. Ct. 579, 76 L. Ed. 1289; and *Cowl* v. *United States*, 8 Cir., 35 F. 2d 794—all hold that a showing of loss to the victim is not necessary to conviction for mail fraud."

The element of loss to the victim referred to by the Court obviously stems from the fact that the mail fraud statute inhibits schemes to defraud, irrespective of their successful consummation. That damage is not a necessary element of mail fraud in no way enlarges the definition of fraud.

So long as the mail fraud statute was confined to cases of common law deceit, the proscribed conduct was definite and readily ascertainable. It was substantially similar to that prohibited by state statutes dealing with larceny by false pretense, trick or device (see *Bentel* v. *U. S.*, 13 F. (2d) 327, 329 (C. C. A. 2d)).

Once the bounds of common law rules are transcended, however, there is no limitation upon the equitable transgressions which may be held to be within the scope of the mail fraud statute. To make the mail fraud statute applicable to every infraction of equitable rules could not have been intended by Congress; it would unquestionably render the statute invalid as vague and uncertain.

Equity intervenes to prevent the taking of any unjust or unreasonable advantage (*Moore* v. *Crawford, supra*). *U. S.* v. *Cohen Grocery Co.*, 255 U. S. 81 held invalid a statute rendering it unlawful for any person to make any *unjust or unreasonable charge* in the sale of necessaries. The Court said, per Mr. Chief Justice WHITE, at page 89:

"Observe that the section forbids no specific or definite act. It confines the subject-matter of the investigation which it authorizes to no element essentially inhering in the transaction as to which it pro-

vides. It leaves open, therefore, the widest conceivable inquiry, the scope of which no one can foresee and the result of which no one can foreshadow or adequately guard against. In fact, we see no reason to doubt the soundness of the observation of the court below, in its opinion, to the effect that, to attempt to enforce the section would be the exact equivalent of an effort to carry out a statute which in terms merely penalized and punished all acts detrimental to the public interest when unjust and unreasonable in the estimation of the court and jury."

If the term "defraud" in the mail fraud statute is not limited to common law fraud, it cannot be said to forbid any specific or definite act. To illustrate the uncertainty of the statute as now interpreted, reference may be made to the following examples of the use for profit of inside information by a fiduciary:

(a) A bondholders' committee member trades in the deposited bonds at a profit to himself, taking advantage of inside information as to the value of the securities (*In re Paramount Publix, supra*).

(b) An officer of a firm of private bankers profits by the purchase for his own account of securities which he might have turned over to another investment company, of which he is a director (*Litwin* v. *Allen, supra;* cf. *Irving Trust Co.* v. *Deutsch, supra*).

(c) An officer of a company develops for himself another business, using, in that connection, facilities of his company (*Guth* v. *Loft, Inc., supra*).

(d) Directors purchase from a large stockholder a large block of preferred stock, the purchase necessarily being based on their intimate knowledge of the company, the stock then being retired by the corporation at a profit to them (*Hauben* v. *Morris, supra*).

(e) The officers of a company purchase its obligations at a discount and seek to enforce them for their full amount against the corporation, the purchase having been made on the basis of knowledge which came to them in the course of their duties (*In re New York Railways Co., supra*).

It is submitted that it cannot now be determined which of these transactions is included within the scope of the mail fraud statute under the definition adopted in this case.

In *Connally* v. *General Construction Company*, 269 U. S. 385, this Court said, per Mr. Justice SUTHERLAND, at page 391:

> "And a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates the first essential of due process of law. *International Harvester Co.* v. *Kentucky*, 234 U. S. 216, 221; *Collins* v. *Kentucky*, 234 U. S. 634, 638."

In *Lanzetta* v. *New Jersey*, 306 U. S. 451, a statute was invalidated which rendered it a crime to be a gangster. A "gangster" was defined as a person not engaged in a lawful occupation, known to be a member of any gang, consisting of two or more persons, who had been convicted at least three times of being a disorderly person, or who had been convicted of any crime in New Jersey or elsewhere. The Court said, per Mr. Justice BUTLER, at page 458:

> "The challenged provision condemns no act or omission; the terms it employs to indicate what it purports to denounce are so vague, indefinite and uncertain that it must be condemned as repugnant to the due process clause of the Fourteenth Amendment."

Under the broad rule stated by the Circuit Court it is impossible to determine the circumstances under which the use for profit of inside information by a fiduciary is a crime.

Circuit Court's Interpretation of Statute Involves Application of Ethical Standard of Conduct Not Enforced in Criminal Cases

The statute, as now interpreted, is not only vague and uncertain, but plainly involves the application of a mere ethical standard of conduct unenforcible in criminal law.

In the leading and frequently cited case of *Meinhard* v. *Salmon,* 249 N. Y. 458, the defendant, one of two joint adventurers, secretly renewed for his own benefit the lease of a hotel previously operated as a joint enterprise. It was held that this involved the appropriation by the defendant for himself of a benefit which should have been shared with the plaintiff.

There was clearly the use by a fiduciary of inside information for his own profit and to the detriment of his *cestui.* The defendant, held accountable in equity, was nevertheless absolved of fraud (pp. 467, 468). Liability was predicated upon the proposition that a fiduciary owes to his *cestui* "the duty of the finest loyalty."

Judge Cardozo described this duty as follows (p. 464):

> "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions (*Wendt* v. *Fischer,* 243 N. Y. 439, 444). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."

This standard of conduct was referred to recently by this Court in *Woods* v. *City Bank Co.*, 312 U. S. 262, at page 269:

> "Only strict adherence to these equitable principles can keep the standard of conduct for fiduciaries 'at a level higher than that trodden by the crowd.' See Mr. Justice Cardozo in Meinhard *v.* Salmon, 249 N. Y. 458, 464; 164 N. E. 545."

A determination of the circumstances under which the use for profit of inside information by a fiduciary involves a breach of fiduciary duty depends in each case upon the application of a standard of conduct defined as "the punctilio of an honor the most sensitive."

In *Irving Trust Co.* v. *Deutsch*, 73 F. (2d) 121 (C. C. A. 2d) corporate directors who profited by a transaction in the securities of another company were held accountable to the corporation for their profit, although it was conceded that they had acted in good faith. The Court said, per SWAN, *C. J.*, at page 124.

> "If the directors are uncertain whether the corporation can make the necessary outlays, they need not embark it upon the venture; if they do, they may not substitute themselves for the corporation any place along the line and divert possible benefits into their own pockets. 'Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions.' Meinhard *v.* Salmon, 249 N. Y. 458, 464, 164 N. E. 545, 546, 62 A. L. R. 1."

This conduct was subsequently held to be an "intentional misappropriation" in *In Re Hammond*, 98 F. (2d) 703 (C. C. A. 2d).

While this standard of conduct may be appropriate in equity or under the bankruptcy statute, it must be clear

that the mail fraud statute was not aimed at deviations from "the punctilio of an honor the most sensitive."

Changing standards of business morality in an era of more complicated business relationships have resulted in closer scrutiny of the conduct of officers and directors. The modern trend is toward increasingly rigid ethics in corporate management and finance. Doctrines of *laissez faire* and *caveat emptor* are now largely relics of a bygone economic era. While no complaint is made of this progress in the law, it is crystal clear that the uncertain and constantly shifting standards of corporate ethics ought not be made the basis of criminal liability.

It is submitted, moreover, that the field of criminal law is not one in which the judiciary may properly seek to shape legal rules in conformity with a developing morality. Even if it were, it is clear that the innovation here adopted is not "within those interstitial limits which precedent and custom and the long and silent and almost indefinable practice of other judges through the centuries of the common law have set to judge-made innovations" (*Cardozo, The Nature of the Judicial Process,* p. 103; see also Mr. Justice Holmes, *Southern Pacific Co.* v. *Jensen,* 244 U. S. 205, 221).

II

The Court erred in holding that non-disclosure by a fiduciary constitutes common law deceit.

In sustaining the conviction in this case, the Circuit Court held that even if the mail fraud statute were limited to common law deceit, non-disclosure by a fiduciary under the circumstances of this case amounted to deceit. The Court, citing *Loewer* v. *Harris,* 57 Fed. 368 (C. C. A. 2d), said:

> "And second, Warriner's silence under the circumstances does amount to common-law deceit; since he was under a positive duty to speak, his silence was a concealment of material facts, of which the board lacked knowledge, and in connection with which they were entitled to rely on him for advice. *Loewer* v. *Harris,* 2 Cir., 57 F. 368."

Loewer v. *Harris, supra,* has no application whatever to fiduciary relationships. In that case, the defendant sold the plaintiff a brewing business upon the basis of a prospectus which, in glowing terms, described its prosperity. These statements were true when made but, before the contract was closed, had become false by reason of a material decline in business. The defendant, having made statements with respect to the business, was obviously under a duty to tell the truth when those statements had become false. The Court so stated, per WALLACE, *C. J.*, at page 373:

> "The law requires disclosure to be made only when there is a duty to make it, and this duty is not raised by the mere circumstance that the undisclosed fact is material, and is known to the one party, and not to the other, or by the additional circumstance that the party to whom it is known knows that the other party is actually in ignorance of it; but when one of the parties, pending negotiations for a contract, has held out to the other the existence of a certain state of facts, material to the subject of the contract, and knows that the other is acting upon the inducement of their existence, and, while they are pending, knows that a change has occurred, of which the other party is ignorant, good faith and common honesty require him to correct the misapprehension which he has created. It becomes his duty to make disclosure of the changed state of facts, because he has put the other party off his guard."

Silence without more is never misrepresentation. Where statements are made which, though literally true, are ren-

dered false by what is not stated, actionable misrepresentation is proved (*Rex* v. *Kylsant* [1932] 1 K. B. 442, 448, 449; *Stewart* v. *Wyoming Cattle Ranche Co.*, 128 U. S. 383, 388; *Tyler* v. *Savage*, 143 U. S. 79, 94, 95).

The distinction between mere silence and concealment which constitutes actionable misrepresentation is summarized in *Bower, Actionable Misrepresentation*, at page 92:

> "Where a man has unnecessarily said something, a duty may at once arise to say more, in which case, if he violates this duty, his reticence thenceforth becomes an implied misrepresentation, though complete silence in the first instance would not have been misrepresentation or even actionable non-disclosure."

This rule as to the circumstances under which non-disclosure becomes misrepresentation has been adopted by Congress in various sections of the Securities Act. In defining a false representation, the Securities Act provides (15 U. S. C. A., § 77q):

> "(a) It shall be unlawful for any person
>
> • • •
>
> "(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, . . ."

See also, 15 U. S. C. A. § 77www(a).

This well established doctrine of common law deceit has never been held to apply to the case of a fiduciary who says nothing. In such a case, the fiduciary is guilty of a breach of trust, not of common law deceit. (*Bower, on Actionable Misrepresentation*, p. 397).

III

The Court erred in determining that the allegations of affirmative misrepresentation had been proved.

Although the Circuit Court held that affirmative misrepresentation was not necessary to sustain the conviction, it nevertheless determined that misrepresentation had been sufficiently proved. On this phase of the case, the instruction of the Trial Court to the jury is vital (fols. 2471, 2472):

> "In this case, for instance, Warriner was president of General Investment Corporation. As president it was his duty under the law, as well as in morals and justice, to acquaint the directors of that company with all that he knew of the circumstances attending the Devendorf stock sale. His silence in that regard, indicated by the minutes of the corporation if you accept them, if intended by him to lull the directors into a belief that they were acting for the best interests of the corporation and doing something in ignorance which they would not have done with knowledge, would be a misrepresentation."

This instruction, therefore, authorized the jury to convict if they found that Warriner had failed in his duty as a fiduciary to make a disclosure of his interest in the transaction. The conviction, therefore, may be said to rest upon this non-disclosure since it was not necessary for the jury to determine that actual misrepresentations had been proved.

The references, therefore, in the opinion of the Circuit Court to affirmative evidence of misrepresentation cannot support the conviction here (*U. S.* v. *Smith*, 112 F. (2d) 83, 86 [C. C. A. 2d]; *U. S.* v. *Koch*, 113 F. (2d) 982, 984 [C. C. A. 2d]). The case was submitted to the jury on a different theory.

But apart from this, it is urged that the evidence of misrepresentation referred to by the Circuit Court does not support the conclusions reached. This matter has been already discussed in the petition (pp. 5, 6), and will not be restated here.

IV

Even if non-disclosure by a fiduciary constitutes deceit, the Court erred in holding that evidence of non-disclosure proved the scheme of affirmative misrepresentation charged in the indictment.

The indictment charged that Warriner made four specific misrepresentations to the directors of G. I. C. (fols. 71-75). The Trial Court instructed the jury that these misrepresentations were proved if they found that Warriner said nothing to the directors (fols. 2471, 2472).

It was argued to the Circuit Court that proof of non-disclosure, even if it established the crime of mail fraud, was not sufficient in this case since mail fraud by misrepresentation had been charged. This claim was not touched upon in the opinion of the Circuit Court. In its opinion, the Court, after determining that misrepresentation had been proved, held that this proof was not essential since the use for profit of inside information by a fiduciary was within the contemplation of the mail fraud statute. The fact that this was not charged was not considered.

A directly contrary result was reached in *Hass* v. *U. S.*, 93 F. (2d) 427 (C. C. A. 8th). In that case, the indictment charged the defendants with having defrauded two fraternal benefit societies by falsely representing that none of the defendant officers or directors would profit from a merger of the two societies. The proof showed that the defendants had taken $300,000 in undisclosed commissions,

but there was no evidence of affirmative misrepresentation. In reversing, the Court said, per SANBORN, *C. J.*, at pages 434, 435:

> "Thus, while charging a scheme to obtain, by means of certain false pretenses, a secret profit from the Foresters and its members as they should exist after merger, the government succeeded in proving a scheme whereby the defendants other than Parks were to obtain, by concealment of facts which they were obligated to disclose, a secret profit from Parks upon completion of the merger.
>
> "Whether the breach of trust of which the defendants who were officers of the Modern Brotherhood were clearly guilty in concealing what it was their duty to disclose, thereby obtaining for themselves money from Parks which the law would not permit them to convert to their own use, would be a scheme or artifice to defraud under section 215, Criminal Code, * * * it is not necessary to determine, since the scheme which was proved was not, in any event, the scheme which the government alleged in the indictment."

It cannot be disputed in this case that the scheme submitted to the jury with reference to Warriner's non-disclosure was not the scheme alleged in the indictment.

Upon this phase of the case, therefore, there is a direct conflict between the decision of this case and the decision of the Circuit Court for the 8th Circuit in *Hass* v. *U. S.*, *supra*.

V

Even if the crime of fraud by misrepresentation could be proved by non-disclosure, the Court erred in holding that non-disclosure had been proved.

It was also argued to the Circuit Court that the government had completely failed to prove that Warriner had not disclosed to the directors everything that he knew concerning the Devendorf stock transaction. Neither Warriner nor any of the directors testified to what Warriner said. Garver, who was present at the meeting, did not testify beyond the minutes, which contained a formal summary of the proceedings and stated that a "thorough discussion" was had (Gov. Ex. 71, fol. 2815). It is entirely consistent with this that Warriner, in the course of the "thorough discussion" made a full disclosure to the directors. The contrary certainly does not appear.

The basis of the conviction in this case, therefore, is that Warriner did not disclose his participation to the directors. This claimed non-disclosure is wholly unsupported by the record. There is not a scintilla of evidence in the case to show what Warriner did or did not say to the directors.

VI

The Circuit Court erred in sustaining the use by the United States Attorney of the Grand Jury process to compel the defendant either to testify or subsequently be cross examined thereon.

Wallace Groves was indicted on December 1, 1938 (fol. 11). The trial started February 6, 1941 (fol. 44). In January, 1941, he was served with a Grand Jury subpoena in his capacity as an officer of certain corporations (fols.

3601-3611). These subpoenas were quashed on motion (fols. 3622-3626).

He was served again a week before the trial began (fol. 1929) and on February 5, 1941, the day before the trial started, he appeared before the Grand Jury (fol. 1930).

On cross examination at the trial, the Government was permitted to ask whether in this Grand Jury proceeding he had declined to answer certain questions on the ground that the answers would tend to incriminate him (fols. 1970-1976). The Grand Jury questions were concerned with whether he was an officer of Nassau Securities, Atlantic Corporation, Gegro Corporation, Foreign Trade Corporation, Montreal Canadian, Ltd. A typical question (fol. 1953) follows:

> "Q. And do you remember testifying before the Grand Jury when you were asked:
>
> 'Q. Were you ever an officer of Nassau Securities Corporation, Ltd.?'
>
> "and you answered:
>
> 'A. I will have to decline to answer on the ground that it would tend to incriminate me.'"

He was also asked whether he had been interrogated before the Grand Jury as to whether he knew where the books of these corporations were and whether he had not asserted his constitutional privilege to that question (fol. 1974).

Timely objections were made (fols. 1962-1969) which were overruled. Exceptions were taken (fols. 1969, 1975, 1976) and a motion was made for a mistrial (fol. 1975).

These questions were not asked for the purpose of showing an attitude before the Grand Jury at variance with the testimony given at the trial, nor for the purpose of affecting his credibility. They were asked solely to show that Groves had asserted his constitutional privilege against self-incrimination.

It is submitted that this practice is an abuse of the Grand Jury process and an infringement of the defendant's constitutional privilege against self-incrimination. The Grand Jury subpoena ought to be used in the investigation of crime and not as a device to compel an already indicted defendant either to disclose his version of the facts or thereafter be confronted with the fact that the day before the trial he admitted that his version of the transaction would incriminate him.

There is nothing in *Raffel* v. *U. S.*, 271 U. S. 494, which sanctions this practice. There, the defendant, having refused to testify in his own behalf at one trial, was compelled to admit that fact when he took the stand at a subsequent trial. The *Raffel* case did not involve the abuse of the Grand Jury process and is not an authority for an examination before trial in criminal cases.

CONCLUSION

It is respectfully submitted that for all of the foregoing reasons and because the Circuit Courts are in conflict on two of the questions presented, the petition for certiorari should be allowed as prayed for.

Respectfully submitted,

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